Summerwood

New thinking for alternative investments

Investing Through Inflation

Why Inflation ~~Is~~ Was Inevitable

April 2022

Investing Through Inflation

A Series of Papers - Index

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Why Inflation ~~Is~~ Was Inevitable

Summary: *An event occurred in 1971 that put us on a historically unprecedented path – fiat money. Fiat is money not backed by anything tangible and no restriction on how much money could be printed. The ultimate result of that decision has to be inflation.*

History doesn't repeat but it often rhymes is an aphorism. An aphorism is 'a pithy observation that contains a general truth'. Because an aphorism is by definition 'pithy' (an excellent word in its own right) people like using them. That doesn't make them right – it makes them pithy.

I reference this pithy quote to raise a cautionary yellow flag in terms of applying it to understanding the markets. Too often analysis resorts to 'this period looks like that period ergo this is how it will resolve'. There's a comfort in believing everything is a cycle or everything mean reverts. History has rhymed often enough to provide that comfort. Doesn't make it so, though.

I prefer to view history as a continuum. We're brought to a point where a decision needs to be made. The proverbial fork in the road. The choice is made, a path followed and eventually consequences ensue. And so on and so on. From a socio-economic perspective I believe there have been four forks-in-the-road that explain how and why we arrived as we are today. There is value in understanding what brought us to a particular fork, what were the choices and most importantly how and by whom was the decision made. It's not as pithy as the opening quote but "you can't understand where you're going if you don't understand how you got here".

The four socio-economic forks of interest to me are the 1919 Treaty of Versailles which in due course begat Bretton Woods which begat the US closing the gold window in 1971 which begat The Greenspan Central Banker. It's too myopic to start with the Greenspan era of central banking. The two earlier points are historically fascinating - one being a treaty and one being an agreement. But both of those have rhymed with past history. To provide context and texture to understand why we are where we are let's go back to 1971. What happened in 1971 set us on a path without historical precedent. An open road untraveled. The historical significance of this event, in my humble opinion, is devastatingly underestimated and overlooked.

Prior to 1971 and as far back as commerce is recorded, sovereign currency was backed by something tangible – usually gold. Bretton

Woods altered this arrangement slightly with a too clever for words adaptation whereby the US would hold the gold and everybody else would peg to the US hoard. In 1971 circumstances prevailed forcing the USofA to "no más" the agreement. They would no longer willingly exchange US dollars for gold. This effectively meant that no currency – anywhere – was tied to a tangible. So begat the fiat economy – currency not backed by anything. If there is no tether there is no limit. In the ensuing fifty years central bankers and policy makers have learned the value and utility of limitlessness. The quantitative easing in response to the Great Financial Crisis through to the $1.7 trillion fiscal package in response to COVID 19 are the mere manifestation of a fiat world.

Milton Friedman, renowned Nobel Prize winner, once famously and succinctly said "inflation is always and everywhere a monetary phenomenon … ". While I am not a monetarist nor a Friedman disciple, I find truth in his quote. The ever-expanding asset base of governments and central banks is equally offset by an ever-expanding debt load. You, me and corporations see debt as an obligation that needs to be repaid. Governments don't seem to need to see debt the same way. There is an understanding that as long as they can grow the economy faster than debt growth (they can't and they aren't) and as long as they can tax (they can but there's a limit before they don't get re-elected) and as long as they can print money (they can and they are) then the debt load is not consequential. Here's the catch. Because each of these three caveats are parenthetically qualified there is a limit. Nothing in the universe is limitless. Currency expansion is not the exception.

Why this matters is because as one sovereign buys another sovereign's debt there needs to be a trust they will be repaid. Trust is the limit. Breach that trust and the end game begins. Sovereigns posture and pose to present fiscal prudence and economic good standing such that the trust limit is not tested or breached. Obviously the most constructive approach is to grow the economy. However, as evidenced by a declining rate of global gross domestic product, that's proving illusory. Other tools of government policy include austerity, repression or taxation. All of which are either politically unacceptable or socially unacceptable. Leaving one last trick to be played – inflation. Paying today's debt with tomorrow's inflated dollars. A tale as old as time. That tale also rhymes with past history.

In summation, and at the risk of oversimplifying a complex notion, in a world where currency has no tangible grounding, there is no limit to its expansion and there is no limit to the offsetting debt load. Debt management tools are limited in scope with the exception being the introduction of inflation as the ultimate debt solution. The destination is chosen. The route taken is being determined. I cannot state this often enough. Fiat is an unprecedented environment. There is no historical precedent, there is no history to rhyme with. Focus less on the path being taken, i.e., the day-to-day market gyrations, and prepare for the ultimate destination as we are currently experiencing – inflation.

Phil Schmitt
President & CEO
Summerwood Capital Corp.

Contact me at;
info@summerwoodgroup.com
LinkedIn